NSW GOVERNMENT | Treasury

Dr Peter Boxall
Chair
IPART
Submitted via online portal

1 June 2018

Dear Dr Boxall,

Response to request for submissions on IPART's issues paper, "Review of our Financeability Test"

NSW Treasury (Treasury) is the owner of a number of regulated utilities that are subject to IPART's oversight and will be affected by any changes to the Financeability Test. These utilities are

- Sydney Water Corporation
- WaterNSW
- Hunter Water Corporation
- Essential Water

This submission provides feedback requested on questions raised in your consultation paper. In general, Treasury is supportive of the proposals in the consultation paper. Treasury is particularly supportive of using inputs for a benchmark efficient business as this would act as a check on the internal consistency of the building block model.

NSW Treasury is supportive of the submissions from the state owned utilities and will rely on them to present their views on points not raised in this letter. NSW Treasury welcomes the opportunity to provide its view on the IPART Issues paper and looks forward to working with IPART on regulation in the future.

Yours sincerely,

[redacted]

Jim Dawson
Executive Director – Commercial Assets
NSW Treasury

Attached: NSW Treasury Submission

NSW Treasury's submission to the IPART review of financeability test 2018

Context and proposed approach

Question 1: *Do you agree with our guiding objectives for the review? Are there other objectives we should consider?*

Treasury believes the Financeability Test should be limited to the benchmark utility and the building block model.

Question 2: *Do you agree that IPART should continue to conduct financeability tests?*

Treasury is supportive of the Financeability Test as long as it acts as an effective check on the building block model.

The purpose of the financeability test

Question 5: *Do you agree with our proposed objectives for the financeability test?*

The objective of the test should be to test the financial viability of a benchmark efficient business, consistent with the approach IPART takes to set prices for the pricing review.

How we implement the test

Question 6: *Do you agree with our preliminary view that we should conduct separate financeability tests, using inputs for a benchmark efficient business and for the actual business?*

Treasury's overriding concern is to use benchmark efficient business inputs as a check on the building block model. We would expect the shareholders/rating agencies to be performing their own analysis ongoing on the actual inputs, however, we are not opposed to IPART using actual inputs as long as they do a separate test on the benchmark business.

Question 7: *Do you agree with our preliminary position that as a default, IPART should conduct the financeability test on the portion of the business that IPART sets prices?*

Yes, we agree that IPART should only look at the portion of the business that they regulate. If the non-regulated/unregulated portion of the business can be deemed to be immaterial, then for ease of calculations, Treasury would agree with conducting the test on the whole business.

Question 8: *Do you agree that we should consider on a case-by-case basis whether to conduct the test using the financial data for the whole business?*

Treasury is of the opinion that the Financeability Test should only relate to the portion of the business that IPART regulates. As above, if the non-regulated/unregulated portion of the business can be deemed to be immaterial, then for ease of calculations, Treasury would agree with conducting the test on the whole business.

<u>Question 9:</u> *Do you agree with the adjustments IPART makes for operating lease expense and pension benefits?*

We are in agreement with IPART on their adjustments for pension benefits and in principal agree with Moody's approach to operating leases, however, we would like to reserve judgement on the adjustments for operating leases until Moody's have finalised their criteria.

<u>Question 10:</u> *Should we consider any other adjustments to the inputs we use to calculate our financial metrics?*

IPART should consider the treatment of managed service contracts in light of the upcoming accounting changes for operating leases.

<u>Question 11:</u> *Do you agree with our preliminary view that we should calculate a real cost of debt in the financeability test?*

Treasury is firmly against using a real cost of debt in the financeability test. The financeability test should use nominal cost of debt. The utilities operate in a nominal world irrespective of the model being a real model. Most utilities are financed using nominal debt and even utilities that use inflation linked debt still have the majority of their debt portfolio in nominal debt. All historical credit metrics have used inputs based on nominal figures. Treasury would be concerned about calibrating the credit metrics to use real figures.

<u>Question 13:</u> *Do you agree with our preliminary view that we should continue to assess a business's financeability over the upcoming regulatory period?*

Yes.

<u>Question 14:</u> *Do you agree with our preliminary view that we should continue to use quantitative data to assess a business's financeability?*

Treasury agrees that IPART should continue to use quantitative data to assess a business's financeability. Any subjective or qualitative overlay should only be considered when determining a remedy to the financeability test.

How we assess financeability

<u>Question 15:</u> *Do you agree with IPART's preliminary view to continue to use a BBB target credit rating across all industries?*

Yes. The BBB target credit rating is consistent with Treasury's own policies regarding the credit rating of State Owned utilities.

<u>Question 16:</u> *Do you think the current metrics are appropriate?*

Treasury is satisfied that the credit metrics used in the Financeability Test are appropriate and similar to metrics used by commercial lenders and ratings agencies. However, Treasury would suggest using an average of historical and forecast data in addition to a point in time calculation to determine an entity's credit metrics.

Question 17: *Are there any additional metrics IPART should use and if so why?*

Treasury would recommend adding a fourth credit metric, Debt Service Coverage Ratio (DSCR). DSCR is a measure of available cash flow to pay all current obligations, both interest and principal. Used in conjunction with an interest coverage test, the DSCR would highlight when an entity's funding is concentrated on current debt. DSCRs are included in many syndicated loan packages and are almost always seen in project finance debt.

Question 18: *How should IPART refine the benchmark ratios for our financial metrics?*

As IPART is using a BBB target credit rating, the ratios should be consistent with the target credit rating using either rating agency criteria or historical statistics for utilities per credit rating. The credit metric benchmark for a particular rating should not overlap with the benchmark for another rating.

Question 19: *Should we rank our financial ratios or adopt a weighting? If you think a ranking is appropriate, are there any improvements we can make to our current rankings?*

Treasury does not believe IPART needs to rank the financial ratios in order of importance. Each metric can potentially shed light on an issue that might not have been identified with another metric.

Question 20: *Should we set out a step-by-step decision process to assess if a financeability problem exists?*

Treasury believes IPART should retain a degree of flexibility to respond to issues that are identified using the Financeability Test. Therefore, Treasury does not expect IPART to have a detailed step-by-step decision process in determining if a financeability problem exists. Treasury does expect the process to determine if a financeability problem exists to have a transparent framework.

Question 21: *Are there any other factors we should consider when we analyse the financial ratios?*

IPART should investigate if any financeability problem highlighted by the test is one off in nature or part of an ongoing trend.

Addressing a financeability concern

Question 22: *Do you think the three stages we have proposed to conduct the financeability test would identify whether a financeability concern is due to: – setting the regulatory allowance too low – the business taking imprudent or inefficient decisions, and/or – the timing of cash flows?*

Treasury are satisfied that the proposed financeability test (incorporating a benchmark and actual test) would identify the concerns listed.

Question 23: *Does our proposed financeability test capture the relevant temporary cash flow problems that might require a timing adjustment to regulated income?*

By using benchmark and actual inputs and a nominal cost of debt, Treasury is satisfied that the proposed Financeability Test will capture temporary cash flow problems.

Question 24: *Do you agree that our proposed remedies to address a financeability concern are appropriate?*

Treasury are supportive of the proposed remedies; however, any remedy must be determined in an open and transparent way.

Question 25: *Are there other remedies that we should consider, and in what circumstances might it be appropriate to apply these remedies?*

Treasury are satisfied with the remedies suggested.

Question 26: *Do you think that any NPV-neutral adjustments to prices should be limited to the upcoming regulatory period?*

IPART should be able to apply NPV-neutral adjustments over more than one regulatory period to address any pricing shock that customers might encounter if the adjustment occurred over only one regulatory period.

Question 27: *Is our proposed process for addressing a financeability concern workable and reasonable?*

Treasury is satisfied that the process is workable and reasonable. Treasury would like to reiterate its desire for an open and transparent process.